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The other kind of Alpha

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Dear Investors and Partners,

Being in the fund management industry for many years and overseeing active mandates across portfolios, I have always seen a constant discussion on manager's alpha, from both advisors and investors. Of course, in recent years in India, this discussion has now turned into a debate as passive strategies have gained foothold. But this letter is not about the debate of active v/s passive in India, but the other kind of alpha which we can think of as Behavior Alpha.

Before we get there though, let's visit an annual study from Morningstar on Investor returns v/s fund returns (titled Mind the Gap)¹. The latest data for US investors suggest that mutual fund and ETFs generated 10-year CAGR of 9.4% (as of Dec 31, 2020), whereas the average investor earned 7.7% CAGR over the same period – a gap of nearly 1.7%. Essentially, attempts to time the market led to this difference in fund return and investor return. Fund return in the above data is easy to understand, which is nothing but the change in NAV over a period, say, last 10 years. However, investor return in the same time period i.e. last 10 years, can be very different. Strikingly, an average investor underperforms the fund consistently as per the Morningstar study.

Investors' attempts to time the markets can include efforts to time cash flows (both through lumpsum or SIP), chasing the best performing strategy based on last 1-year returns or missing the best performing months in the last 10 years that practically generated the entire alpha. Investors may also miss out by not catching the growth cycle of the fund's underlying strategy. For example, in case of sectoral funds, an average investor may be typically late to enter the "hot" theme or exit too early. So, think about it this way, even if one is investing in a passive fund (thus eliminating active manager alpha risk and any potential upside as well), one may still end up underperforming, because of one's own behavioral biases and attempts to time the market.

There are numerous types of biases that cause this behavior - Loss aversion bias (tendency to avoid losses), Overconfidence bias (overestimate one's abilities), Recency bias (the most recent big negative or positive event in the markets and economy influencing decision making), Anchoring bias (attributing undue importance to certain price levels) - to name a few. There are other factors too like tax efficiency and investment costs, but cash flow timing decisions remain the biggest determinant of returns.

Apart from a pure buy and hold strategy, the above gap can be offset to a great extent, in my opinion, by having a trusted advisor manage your investments. This is the best behavior hack. I have a financial advisor who has been managing my investments for many years now. As you can guess, the trick lies not in the technical acumen that an advisor brings to the table (that's a given) but the influence he can exert on my behavior as a long-term investor.

The value of having an advisor is more as a behavior coach. Many a times, managing money involves emotion and the need to guard against our own biases. An efficient advisor can help in reducing financial anxiety, and focus on having a plan, especially when markets are going through a rough phase. In such situations, an investor may take decisions based on one's emotions. However, an advisor can bring in a third person's perspective, helping make logical decisions rather than emotional. Even though an investor may be aware of the various behavioral biases, countering them in real-life decision-making is easier said than done. This is where an advisor plays a role by constantly re-orienting one's thinking towards long-term and end goals. A trusted advisor can also add value by being a sounding board in life's major financial decisions like for e.g. to rent or to buy a house.

In India, I have seen an increasing number of advisors focusing on asset allocation as a starting point. This strategy's in-built characteristics help an investor to buy-and-hold for the longer term. The success of balanced advantage funds as a category can be explained due to this phenomenon. The automated rebalancing helps a client curb his behavior bias of chasing returns in the best performing fund or asset class in the short term. Another aspect which advisors in India have focused on is to promote diversification. Thus within equities, Flexicap and Multicap category have emerged stronger.

As you can see, the importance of having an advisor is immense. The behavior alpha that I started the letter with can alternatively be termed as Advisors Alpha – which is the other type of alpha – focused on making sure that you participate fully in the opportunities provided by mutual funds as a whole.

Stay safe & happy investing.

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¹ Evaluating the Gap Between U.S. Investor Returns and Official Total Returns, Morningstar

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